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SUBJECT: CHINA: NEW MERGER RULES SPARK CONCERN

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11. (SBU) Summary. On August 8, the Ministry of Commerce (MOFCOM) released new regulations governing foreign acquisitions of domestic enterprises. Local observers were pleased that the regulations allow for equity swaps but are concerned with vague language that appears to give MOFCOM considerable discretion to block or delay deals. Despite assertions from MOFCOM officials from the Minister on down that the new regulations do not signal a shift in China's openness to foreign direct investment (FDI), virtually all of our Beijing-based U.S. business contacts believe the regulations reflect a general rise in economic protectionism. Furthermore, embassy contacts in industry, investment banking and legal services all report significant new difficulties in completing foreign acquisitions involving a controlling stake of a Chinese company. END SUMMARY.

Overview of New Regulations

12. (U) The new M&A regulations were jointly drafted and issued by six different ministries: MOFCOM, the State-owned Assets Supervision and Administration Commission (SASAC), the State Administration of Taxation (SAT), the State Administration of Industry and Commerce (SAIC), the China Securities Regulatory Commission (CSRC) and the State Administration of Foreign Exchange (SAFE). These regulations serve to strengthen MOFCOM's

supervisory role, in part by requiring its approval of deals it believes impact state economic security or involve famous Chinese brands. They also thrust MOFCOM into the role of determining if the acquisition target has been appropriately valued. The only positive aspect that U.S. industry sees in these regulations is the creation of a legal framework for cashless, stock swap-based mergers or acquisitions.

¶3. (SBU) The regulations went into effect on September 8 - thirty days after they were made public. MOFCOM Department of Treaty and Law Director General Shang Ming told EB/CBA Special Representative Mermoud in late August that the regulations were circulated to government offices, law firms, and companies for comment. However, the local American Chamber of Commerce reports that regulators did not seek comments from American firms in a broad or meaningful way. We are unaware of any WTO member state governments having been afforded opportunity to comment prior to issuance of the regulations on August 8. A major U.S. investment bank also relayed to us that CBRC officials had expressed concern with the way the regulations were drafted and would look to the implementing rules process to correct deficiencies.

Problem Areas

¶4. (SBU) Multiple U.S. industry contacts have identified the following elements of the regulations as worrisome:

A) Article 12 calls for MOFCOM's approval of any

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deal involving a "major industry", having "impact on the state economic security" or concerning "famous trademarks or traditional Chinese brands." This vague language is so inclusive that industry believes it will allow MOFCOM to prevent any deal at will.

B) Article 14 requires that MOFCOM approve the valuation of any merger or acquisition. It is unclear who will be able to qualify as a mandatory "relevant asset appraisal organ." This clause could be used to block deals by inflating asset valuation. MOFCOM Department of Treaty and Law Director Wen Xiantao recently told EB/CBA Special Representative Frank Mermoud that this article was drafted because recently a number of Chinese firms had been sold off too cheaply and MOFCOM wanted to ensure that foreign firms paid "the right price." Director Wen was unable to answer questions about what qualifications and experience will be required of the accountants who determine the appropriate valuation, nor was he able to clarify on what basis they would determine the value. Wen said that these questions were too technical and suggested that such inquiries be directed to the Ministry of Finance.

C) Article 30 requires an "acquisition consultant" be hired to complete a stock swap-based deal. Article 31 lays out subjective guidelines as to who will be able to qualify as such a consultant. The guidelines include the requirements that the acquisition consultant have a "good reputation", no "significant" criminal record and the "capability to conduct" the investigation. These subjective regulations could be used to qualify or disqualify potential acquisition consultants at MOFCOM's whim.

D) Chapter 5 of the regulations requires MOFCOM approval for any deal that meets specific criteria or involves "very large market share" or "other important factors" that affect competition. Again, this law is so subjective as to give MOFCOM a free hand to block or approve of any deal as it sees fit based on undefined antimonopoly rationale. When asked about this provision, Director General Shang Ming explained that

this provision will only be used until a broad anti-monopoly law is passed. At that point, the anti-monopoly law will trump the anti-monopoly provisions in these regulations.

Anecdotal Confirmation

15. (SBU) Although it is difficult to gather statistics on whether completing a merger or acquisition in China has become more challenging for foreign companies or not, all of the anecdotal evidence suggests that it has. A representative from JPMorgan recently told econoff that all foreign acquisitions his firm is working on that involve acquisition of a controlling stake in a Chinese firm are "dead in the water," although deals involving minority stakes are still going through. A representative from Caterpillar told econoff that Caterpillar is no longer able to secure approval to acquire Chinese companies, although greenfield investments are still proceeding. At a recent AmCham Board of Governors meeting all members present agreed that they were finding it increasingly difficult to gain regulatory approval for investment in China. There are also a number of high profile international deals - including Carlyle's proposed acquisition of Xugong machinery, Citibank's attempted

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investment in Guangdong Development Bank, and French firm SEB's proposed takeover of Zhejiang Supor cookware - that have stalled or failed and become frequently featured, usually negatively, in Chinese media. Many contacts have reported that although it is increasingly difficult to gain control of a Chinese firm, it is still possible to secure a minority stake, especially if the foreign firm is willing to transfer technology as part of the deal.

16. (SBU) Contacts are divided on what the source of the opposition to foreign investment is. However, all agree that it is primarily directed at foreign firms seeking control of existing Chinese companies. Some U.S. industry representatives believe that it is general economic protectionism, some that it is part of a desire to develop globally recognizable Chinese brands and some that it is a reaction to a perception that WTO requirements have given too much to foreign firms for too little. Regardless of the reasons behind it, the volume of evidence suggesting that China is becoming less welcome to foreign investment, especially when it involves ceding control of a Chinese firm to a foreign one, is difficult to ignore.

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